European Securities and Markets Authority

Date: 24 January 2020
ESMA70-155-6347

OPINION on position limits on Phelix DE Base Power contracts

I. Introduction and legal basis

1. On 10 October 2018, the European Securities and Markets Authority (ESMA) received a notification from the Federal Financial Supervisory Authority (BaFin) under Article 57(5) of Directive 2014/65/EU on markets in financial instruments[1] ("MiFID II") regarding the exact position limits BaFin intends to set for Phelix DE Base Power Futures and Options commodity contracts in accordance with the methodology for calculation established in Commission Delegated Regulation (EU) 2017/591 supplementing Directive 2014/65/EU of the European Parliament and of the Council with regard to regulatory technical standards for the application of position limits in commodity derivatives[2] ("RTS 21") and taking into account the factors referred to in Article 57(3) of MiFID II. Additional information was received on 16 October 2019.

2. ESMA's competence to deliver an opinion is based on Article 57(5) of MiFID II. In accordance with Article 44(1) of Regulation (EU) 1095/2010 of the European Parliament and of the Council of 24 November 2010 establishing a European Supervisory Authority (European Securities and Markets Authority)[3] ("ESMA Regulation"), the Board of Supervisors has adopted this opinion.

II. Contract classification

Commodity base product: energy (NRGY)

Commodity sub product: electricity (ELEC)

Commodity further sub product: base load (BSLD)

Name of trading venue: EUROPEAN ENERGY EXCHANGE

MIC: XEEE

Venue product codes: DEB and O2B

[1] Directive 2014/65/EU of the European Parliament and of the Council of 15 May 2014 on markets in financial instruments and amending Directive 2002/92/EC and Directive 2011/61/EU (OJ L 173, 12.6.2014, p. 349).
[2] Commission Delegated Regulation (EU) 2017/591 of 1 December 2016 supplementing Directive 2014/65/EU of the European Parliament and of the Council with regard to regulatory technical standards for the application of position limits commodity derivatives (OJ L 87, 31.3.2017, p. 479).
[3] Regulation (EU) 1095/2010 of the European Parliament and of the Council of 24 November 2010 establishing a European Supervisory Authority (European Securities and Markets Authority), amending Decision No 716/2009/EC and repealing Commission Decision 2009/77/EC (OJ L 331, 15. 12.2010, p. 84).

III. Market description

3. The Physical Electricity Index (Phelix) refers to the base load (Phelix Base) and peak load (Phelix Peak) price index published daily on the Power Spot Market for the German market area. The Phelix is established by EPEX (European Power Exchange) SPOT and constitutes the underlying asset for the European Energy Exchange (EEX) Phelix Futures contract.

4. In 2017, EEX launched financially settled power futures for Germany (Phelix-DE Future) in response to the planned split of the German-Austrian price zone. The Phelix DE Power Future and Option contracts are derivatives contracts referring to the average power spot market prices of future delivery periods of the German market area. The Phelix-DE Future enables hedging against price risk for the German Power market. Phelix-DE Futures are available as base load and peak load contracts. Gradually, they are substituting the Phelix DE/AT contracts as Phelix DE has a constantly rising open interest. This shift of liquidity is due to the recent split of the bidding zones of Germany and Austria.

5. The Phelix DE Base Futures contracts are financially settled derivatives contracts referring to the average power spot market prices of future delivery periods of the German market area. Maturities in the Phelix DE Baseload Futures include Day, Week, Weekend, Month, Quarter and Year contracts. The furthest maturity to trade is 6 years.

6. EEX also offers trading in options on the Phelix-DE Base Future (Month, Quarter, Year). In addition, EEX offers four expiry dates for options on Phelix-DE Base Year Futures, the so-called Short Dated Options. Regardless of the different maturities, the corresponding futures position of the underlying asset is booked upon exercising of the option.

7. Electricity is a grid-bound commodity, where delivery takes place through meshed transmission system grids. This means that market participants have no control over the actual destination of the generated power. Electricity can only be stored to a very minimal extent, i.e. by means of battery storage. Furthermore, prices of derivatives markets are closely related to spot markets. There are also some seasonal effects in the electricity market. Due to heating demand in winter or higher demand in summer due to air-conditioning, electricity generation tends to be higher in times of climatic extremes. However, such seasonal effects are small.

8. Since the electricity system constitutes a critical infrastructure, the German power market is subject to close surveillance of national and European regulators, including supervision for the purpose of the prevention of abusive practices of dominant positions. Similar to financial markets, REMIT prohibits market manipulation of the spot market.

9. There is a high number of producers and their role in the market is very diverse. In Germany about 700 companies are holding a license to supply electricity to retail clients. Germany is currently in a process of fundamental market design changes ('Energiewende'). At the same time, more and more renewable energy generation facilities and new generation companies are entering the market. Though former German market leaders RWE and E.ON have now

broken up Innogy, whose assets are divided among parent RWE and rival E.ON. It is expected that this deal is going to strengthen RWE's production capacities and E.ON's grid business, which could lead to more market concentration. However, as the deal has not been fully executed yet, it is not taken into account in this assessment.

10. The Monopolies Commission has submitted its Special Report on the development of competition in the market of grid-bound electricity.[4]. Based on the assessment of the so-called Residual Supply Index and the Return on Withholding Capacity Index by means of which market power has been examined, it has concluded that since 2012 Germany's four biggest energy producers do not have a dominant position in the market anymore.

IV. Proposed limit and rationale

Spot month position limit

Deliverable supply

11. Deliverable supply amounts to 155,449,850 MWh.

12. The deliverable supply was estimated based on statistics provided by ENTSO-E (European Network of Transmission System Operators for Electricity). It is composed of the domestic Net Generating Capacity (NGC) of Germany as displayed on the Website of ENTSO-E for the year 2018 and the average yearly import capacity of Germany for 2018. As ENTSO-E displays only figures for the zone DE-AT-LU, imports and NGC of Austria and Luxemburg were deducted. The necessary data for Austria and Luxemburg has been gathered from national energy regulators and ENTSO-E data on a national basis.

13. These values of ENTSO-E have been converted from MW to MWh per year. The overall value was then divided by the factor of 12 in order to align the deliverable supply to the time frame of one calendar month for the spot month period (30 days).

Spot month position limit

14. The spot month limit is set at 40,416,961 MWh, which represents 26% of the deliverable supply. The spot month limit applies to Phelix DE Base Futures and Options contracts. The spot month (=calendar month) includes daily contracts, weekend contracts, weekly contracts and monthly contract.

Spot month position limit rationale

15. The baseline figure for the spot month was calculated as 25% of the estimated deliverable supply, i.e. 25% * 155,449,850 MWh = 38,862,463 MWh.

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[4] https://www.monopolkommission.de/images/PDF/SG/s77_volltext.pdf

16. BaFin considered the following factor relevant for adjusting the baseline upwards:

- Article 20(2)(d) of RTS 21: upward adjustment due to the lack of storage capacity, leading the underlying market to be less prone to market manipulation.

17. All other factors have been considered by BaFin and are not regarded as material or relevant to require additional adjustments, either up or down, from the baseline. In considering the volatility in the contract, as required by Article 21 of RTS 21, BaFin has noted that there has been some variation in the price of the commodity derivative but has not found evidence that this is excessive or that lower position limits would reduce volatility.

18. Based on the above, BaFin decided to increase the spot month limit by 1 percentage point over the baseline, which results in a spot month limit of 40,416,961 MWh representing 26% of the deliverable supply.

Other months' position limit

Open interest

19. Open interest amounts to 838,991,280 MWh. The open interest value was provided by the exchange. It was calculated by aggregating all contracts across all maturities and converting them to MWh. The number provided is the average size of daily open interest throughout April, May, June and July 2018. The open interest of Phelix DE is constantly rising. Since the introduction of the last set of position limits open interest has more than doubled. This is due to the split of the price zone between Germany and Austria resulting in a shift of liquidity from Phelix DE/AT contracts to Phelix DE contracts. The most recent months are therefore considered the most meaningful. Option positions have been delta adjusted.

Other months' position limit

20. The other months limit amounts to 209,747,820 MWh, which represents 25% of combined open interest. The other months' limit applies to Phelix DE Base Futures and Options contracts.

Other months' position limit rationale

21. The baseline figure for the other months limit amounts to 25% of open interest, i.e. 209,747,820 MWh.

22. In accordance with Article 16(2) of RTS 21, BaFin considered that an upward adjustment was justified due to large number of separate expiries (10 monthly contracts, 11 quarterly contracts and 6 yearly contracts). In contrast to daily and weekly contracts that fall into the spot month, quarterly and yearly contracts are traded in significant volumes.

23. As open interest is significantly higher than the deliverable supply, BaFin deemed relevant to adjust the limit downwards in accordance with Article 18(2) of RTS 21.

24. All the other potential adjustment factors set out in RTS 21 have been considered by BaFin and are not regarded as material or relevant to require additional adjustments, either up or down, from the baseline. In considering the volatility in the contract, as required by Article 21 of RTS 21, BaFin has noted that there has been some variation in the price of the commodity derivative but has not found evidence that this is excessive or that lower position limits would reduce volatility.

25. Based on the above, BaFin considered that the factors justifying an upward and a downward adjustment from the baseline outweigh each other. This results in a limit of 209,747,820 MWh representing 25% of the open interest.

V. ESMA's Assessment

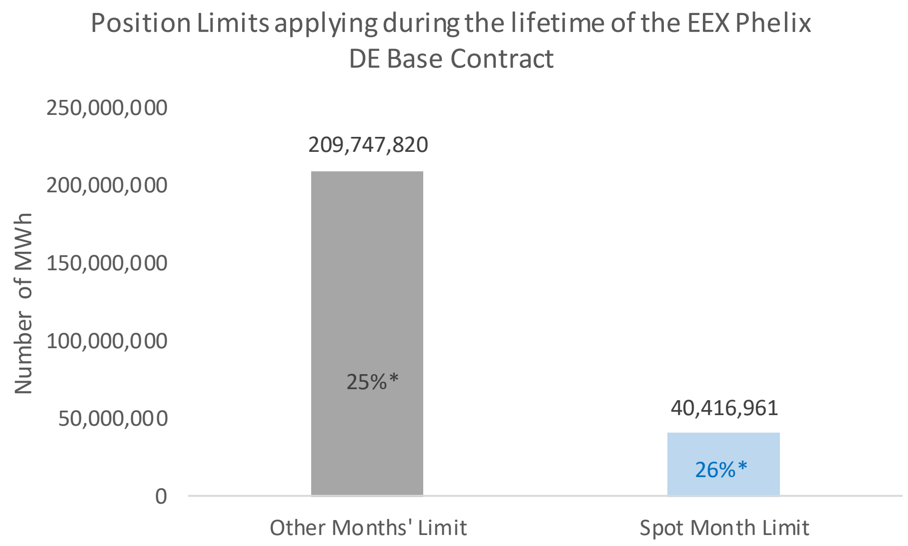
26. This Opinion concerns positions held in Phelix DE Base Power Futures and Options contracts.

27. ESMA has performed the assessment based on the information provided by BaFin.

28. For the purposes of this Opinion, ESMA has assessed the compatibility of the intended position limits with the objectives of Article 57(1) of MiFID II and with the methodology for calculation of position limits established in RTS 21, in accordance with Article 57(3) of MiFID II.

Compatibility with the methodology for calculation of position limits established in RTS 21 in accordance with Article 57(3) of MiFID II

29. BaFin has set one position limit for the spot month and one position limit for the other months.



*Position limit as % of Open Interest

*Position limit as % of Deliverable Supply

<u>Spot month position limit</u>

30. The calculation of the deliverable supply is based on ENTSO-e figures for 2018. As ENTSO-e figures for the German market also include Austria and Luxembourg, ESMA considers appropriate to have deducted imports and NGC of Austria and Luxemburg based on data provided by national regulators.

31. ESMA agrees with the methodology used to include both domestic generation plus imports into Germany. Whilst the physical delivery of power depends on the actual number of days of the month, ESMA also agrees with using 30 days (average calendar days in a month) and 24h per day to calculate monthly deliverable supply, in order to standardize the monthly deliverable supply of power for these baseload contracts. This approach is consistent with Article 10(2) of RTS 21 that sets out that “Competent authorities shall determine the deliverable supply […] by reference to the average monthly amount of the underlying commodity available for delivery over the one year period immediately preceding the determination”.

32. ESMA considers as a reasonable approach to have slightly adjusted the spot month limit upwards under Article 20(2)(d) of RTS 21 to take into account the lack of possibility to store the underlying market, which makes it less prone to market manipulation.

<u>Other months’ position limit</u>

33. The open interest was calculated as the daily average of open interest during the four most recent months in 2018 prior to the setting of the position limit by the competent authority

after aggregating all contracts across all maturities and converting them to MWh. ESMA considers such an approach sensible in this case as the open interest in the Phelix DE Base Power Futures and Options contracts is constantly increasing in response to the split of the German-Austrian price zone. ESMA also considers such approach consistent with Article 12 of RTS 21.

34. ESMA agrees that a downward adjustment of the position limit from the baseline was justified under Article 18(2) of RTS 21 as the open interest is significantly higher than the deliverable supply.

35. ESMA also agrees that an upward adjustment was justified under Article 16(2) of RTS 21 due to the large number of separate expiries.

36. Consequently, these position limits have been set following the methodology established by RTS 21.

Compatibility with the objectives of Article 57(1) of MiFID II

37. ESMA has found no evidence indicating that the proposed position limits are not consistent with the objectives of preventing market abuse and supporting orderly pricing and settlement conditions established in Article 57(1) of MiFID II.

38. Overall, the position limits set for the spot month and the other months appears to achieve a reasonable balance between the need to prevent market abuse and to ensure orderly pricing and orderly settlement, while also ensuring that the development of commercial activities in the underlying market and the liquidity of the Phelix DE Base Power contracts are not hampered.

VI. Conclusion

39. Based on the considerations and analysis presented above, it is ESMA's opinion that the spot month position limit does comply with the methodology established in RTS 21 and is consistent with the objectives of Article 57 of MiFID II. The other months' position limit does also comply with the methodology established in RTS 21 and is consistent with the objectives of Article 57 of MiFID II.

Done at Paris, 24 January 2020

Steven Maijoor

Chair

For the Board of Supervisors